IN THE COURT OF APPEALS OF TENNESSEE
AT NASHVILLE
March 11, 2009 Session

TEKSYSTEMS, INC. AS SUCCESSOR-IN-INTEREST BY MERGER TO MAXIM GROUP, INC. v. REAGAN FARR[1], COMMISSIONER OF REVENUE, STATE OF TENNESSEE

Appeal from the Chancery Court for Davidson County
No. 06-177-III Ellen Hobbs Lyle, Chancellor

No. M2008-01909-COA-R3-CV - Filed May 11, 2009

This is an action by a staff augmentation company challenging the assessment by the Tennessee Department of Revenue of $2,362,692 in sales taxes, penalties, and accrued interest. The plaintiff specializes in providing, on a temporary basis, information technology professionals who work in the information technology departments of its clients providing programming services as directed by the clients. While working at the offices of the clients under the direct supervision of and at the direction of the clients, the plaintiff's employees fabricated software within the meaning of Tenn. Code Ann. § 67-6-102(36)(B). The Commissioner deemed the service taxable as the sale of tangible personal property because the plaintiff's contract with its clients expressly stated that it was "an independent contractor." The plaintiff, however, contends the services rendered by its employees come within the so-called "in-house exemption" afforded by Tenn. Code Ann. § 67-6-102(36)(B), because its employees functioned as agents of the clients, not as independent contractors, and the fabrication of the software is for the clients' own use. The trial court concluded that the plaintiff's employees functioned as agents of the clients in "fabricating, installing and repairing the clients' software," that the in-house exemption applies and, thus, the service is not subject to the tangible personal property sales tax. We affirm.

Tenn. R. App. P. 3 Appeal as of Right; Judgment of the Chancery Court Affirmed

FRANK G. CLEMENT, JR., J., delivered the opinion of the court, in which RICHARD H. DINKINS, J., and D. MICHAEL SWINEY, SP. J., joined.

Robert E. Cooper, Jr., Attorney General and Reporter; Michael E. Moore, Solicitor General; and Talmage M. Watts, Assistant Attorney General, for Reagan Farr, Commissioner of Revenue, State of Tennessee.

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[1] Commissioner Reagan Farr has been substituted as a party in the place of Commissioner Loren L. Chumley in accordance with Tenn. R. App. P. 19(c).

Michael D. Sontag and Stephen J. Jasper, Nashville, Tennessee, for the appellee, Teksystems, Inc., as Successor-in-Interest by Merger to Maxim Group, Inc.

J. Mark Tipps, Joseph F. Wellborn, III, and Lauren B. Patten, Nashville, Tennessee, for amici curiae, American Staffing Association and National Association of Computer Consultant Businesses.

OPINION

Teksystems, Incorporated filed this action, as the successor-in-interest to Maxim Group, Inc.,[2] challenging the assessment of $2,362,692.17 in sales taxes, penalties, and accrued interest, which the Tennessee Department of Revenue assessed against Maxim following an audit for the period of October 1, 1998 through December 31, 2000.

The Department imposed the tax for the "sale" of computer software by Maxim to its client companies (hereinafter "clients"). The taxes were imposed pursuant to Tenn. Code Ann. § 67-6-201(1) (2006) and Tenn. Code Ann. § 67-6-102(36)(B) (2006). Tennessee Code Annotated § 67-6-201(1) provides that taxes may be imposed upon a person who engages "in the business of selling tangible personal property at retail in this state." Tennessee Code Annotated § 67-6-102(36)(B) provides that the sale of tangible personal property includes the "transfer of customized or packaged computer software, which is defined to mean information and directions loaded into a computer which dictate different functions to be performed by the computer, whether contained on tapes, discs, cards, or other devices or materials."

Maxim was a staff augmentation business providing information technology professionals to its clients for the purpose of programming software on computers used solely by the clients. Maxim had numerous clients in Tennessee and across the country. The client's staff augmentation needs typically arose because of scheduling demands with respect to a specific IT function, project or support activity; insufficient in-house expertise when the project team of a client's internal employees would benefit from the assistance of individuals who had been trained in a unique application or discipline; or an intensive, short-term IT project requiring supplemental IT staff.

The augmentation of IT specialists was provided pursuant to two agreements with each client. The general operating agreement between Maxim and each of its clients was titled "Professional Service Agreement." The other, titled "Work Order," set forth the scope of the services to be performed on a given project for the client and the identify of the employees assigned to that project.

Maxim's Professional Service Agreement with International Paper, its largest client in Tennessee during the audit period, is typical of its agreements with the other clients. Paragraph 2.1 of the Agreement with International Paper, in which Maxim is identified as "Contractor," stated:

[2] Maxim Group, Inc., merged with and into Teksystems, Incorporated prior to the commencement of this action. Teksystems is the successor-in-interest to all rights and responsibilities of Maxim related to this action.

> Contractor will provide Contractor Employees to [International Paper] or its Affiliates to work on various projects during the term of this Agreement as may be requested by [International Paper] or any Affiliate. The scope of the Services to be performed on a project and the Contractor Employee assigned to perform the Services shall be set forth in individual Work Orders. The Services shall commence on the Start Date set forth in a Work Order and cease on the End Date set forth therein. The Work Orders shall be made a part of and incorporated in this Agreement upon execution by both parties. In the event of a conflict between the terms of this Agreement and a Work Order, the terms of this Agreement shall prevail.

The Professional Service Agreement also stated that Maxim would "perform the services under this Agreement as an independent contractor," and that "[n]o agency or employment relationship is intended nor shall be construed to exist between International Paper and [Maxim] or between International Paper and any employee of [Maxim] who performs Services under this Agreement. . . ." The Agreement also stated that Maxim shall provide contract employees as requested by the client from time to time, that such employees shall provide services under client's management and supervision at a facility or in an environment controlled by client, that Maxim does not warrant that the contract employees will produce any particular result because Maxim is providing supplemental staffing services only, and that the client is directing and supervising the contract employees who render these services.

Following the filing of this action, extensive discovery ensued.[3] Thereafter, cross-motions for summary judgment were filed. In its motion for summary judgment, the Commissioner principally relied on the language in the Professional Service Agreements, which identified Maxim as an independent contractor, not an agent of its clients, and on the undisputed fact that it was Maxim's employees who loaded information and directions into the clients' computers which dictated different functions to be performed by the computers. Based upon these undisputed facts and Tenn. Code Ann. § 67-6-102(36)(B), the Department argued that Maxim was engaged "in the business of selling tangible personal property at retail" and the transactions were subject to the sales tax on tangible personal property.

Conversely, Teksystems contended the "in-house" software exemption under Tenn. Code Ann. § 67-6-102(36)(B) applied because the undisputed facts established that Maxim merely provided temporary IT professionals to the clients, the clients controlled their activity and direction of the software creation performed by the IT employees, and the software was used by the clients for the client's sole use.

Following a hearing on the cross-motions, the Chancellor granted summary judgment in favor of Teksystems. The Chancellor found that there were no genuine issues of material fact, that the

[3] The discovery focused on International Paper, Incorporated as it was the Plaintiff's largest client and the company from which the most complete records were available. The discussion and analysis of the Plaintiff's business operations in this opinion will be based upon their relationship with International Paper.

contract employees functioned as agents of the clients in fabricating, installing and repairing the clients' software, and, therefore, the tax exemption applied.

STANDARD OF REVIEW

Summary judgments do not enjoy a presumption of correctness on appeal. *BellSouth Adver. & Publ'g Co. v. Johnson*, 100 S.W.3d 202, 205 (Tenn. 2003). This court must make a fresh determination that the requirements of Tenn. R. Civ. P. 56 have been satisfied. *Hunter v. Brown*, 955 S.W.2d 49, 50-51 (Tenn. 1997).

No genuine material factual disputes are presented. The issue presented hinges on the proper interpretation of Tennessee statutes and their application to the facts of this case. Issues involving the construction of statutes and their application to facts involve questions of law. *Memphis Publ'g Co. v. Cherokee Children & Family Servs., Inc.*, 87 S.W.3d 67, 74 (Tenn. 2002); *Waller v. Bryan*, 16 S.W.3d 770, 773 (Tenn. Ct. App. 1999). We will review the issues de novo and reach our own independent conclusions regarding them. *King v. Pope*, 91 S.W.3d 314, 318 (Tenn. 2002).

ANALYSIS

In an action challenging the assessment of sales taxes, penalties and interest, the Commissioner bears the initial burden of proving that Teksystems is subject to the sales tax at issue. *Sodexho Mgmt. v. Johnson*, 174 S.W.3d 174, 177 (Tenn. Ct. App. 2004) (citing *Prodigy Services Corp. v. Johnson*, 125 S.W.3d 413, 416 (Tenn. Ct. App. 2003)). Once this is established, the taxpayer bears the burden of proving that it is exempt. *Id*. (citing *Jack Daniel Distillery, Lem Motlow, Prop. v. Johnson*, 740 S.W.2d 413, 416 (Tenn. 1987)). There is a presumption against exemptions. *Id.* (citing *Kingsport Publishing Corp. v. Olsen*, 667 S.W.2d 745, 746 (Tenn. 1984)).

THE RETAILERS' SALES TAX ACT AND "IN-HOUSE" SOFTWARE EXEMPTION

The Retailers' Sales Tax Act, Tenn. Code Ann. § 67-6-101 et seq., is a comprehensive taxing statute, which levies a sales tax for the privilege of selling tangible personal property in Tennessee and, as a supplement thereto, also levies a tax on the use of tangible personal property in Tennessee. *Creasy Systems Consultants, Inc. v. Olsen*, 716 S.W.2d 35, 35-36 (Tenn. 1986). "The scheme of taxation is to tax equally all sales of tangible personal property in Tennessee and all those who import and use it." *Id*. (citing *University Computing Co. v. Olsen*, 677 S.W.2d 445, 446 (Tenn. 1984)).

For the audit period at issue, October 1, 1998 through December 31, 2000, a "sale" was defined in Tenn. Code Ann. § 67-6-102(36)(B) (2006) as:

> . . . any transfer of title or possession or both, exchange, barter, lease, or rental, conditional, or otherwise, in any manner or by any means whatsoever of tangible personal property for a consideration, and includes the fabrication of tangible

personal property for consumers who furnish, either directly or indirectly, the materials used in fabrication work, . . .

The statute expressly provides that the sale of computer software constitutes the sale of tangible personal property. *Id*. The statute further provides that the sale of computer software includes the transfer of customized or packaged computer software, which is defined to mean "information and directions loaded into a computer which dictate different functions to be performed by the computer, whether contained on tapes, discs, cards, or other devices or materials." *Id*. It is undisputed that Maxim's employees loaded information and directions into its clients' computers which dictated different functions to be performed by the computers. Therefore, the services rendered by Maxim are subject to the sales tax unless Teksystems, as Maxim's successor-in-interest, can establish that the in-house exemption applies. *See Sodexho Mgmt.*, 174 S.W.3d at 177 (citing *Jack Daniel Distillery,* 740 S.W.2d at 416) (holding the burden is on the taxpayer to establish that it is exempt).

The statutory in-house exemption reads as follows: "the fabrication of software *by a person for such person's own use or consumption* shall not be considered a taxable 'use' under subdivision (36) or any other section of this chapter."[4] Tenn. Code Ann. § 67-6-102(36)(B) (2006) (emphasis added). The exemption has two components. First, the software must have been "fabricated" by the person or entity seeking the exemption. *Lockheed Martin Energy Sys. v. Johnson*, 78 S.W.3d 918, 924 (Tenn. Ct. App. 2002). Second, the software must have been fabricated for the fabricator's own use or consumption. *Id*.

It is undisputed that the only users of the software fabricated by Maxim's employees were the clients. Moreover, the clients were the exclusive owners of the software. Therefore, the dispositive issue is whether Maxim's employees functioned as agents of Maxim's clients or as independent contractors. If they functioned as agents of the clients, the exemption applies. *See Sodexho*, 174 S.W.3d at 177-78 (citing *U.S. v. Boyd*, 378 U.S. 39, 44-48 (1964); *Gehl Corp. v. Johnson*, 991 S.W.2d 246 (Tenn. Ct. App. 1998)) ("[B]ecause an agent . . . steps into the shoes of its tax-exempt client when it is a servant of that client."). If, however, they were independent contractors, the exemption does not apply and Maxim was subject to taxation.

THE SURROUNDING FACTS AND CIRCUMSTANCES DETERMINE THE RELATIONSHIP

Teksystems contends the issue is controlled by the Tennessee Supreme Court's opinion in *United States v. Boyd*, 363 S.W.2d 193 (Tenn. 1962), *aff'd* 378 U.S. 39 (1964), and its progeny, each of which stand for the proposition that the surrounding facts and circumstances determine whether

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[4] The codification of this provision within the Tennessee Code has changed over the years, and was deleted by a 2007 amendment. The statutory provision was codified at Tenn. Code Ann. § 67-6-102(36)(B) in 2006 and was in effect during the audit period from October 1, 1998 to December 31, 2000.

one is an agent of another or an independent contractor.[5] Conversely, the Commissioner contends that *Boyd* has been preempted by another Tennessee Supreme Court decision, *Creasy Systems v. Olsen*, 716 S.W.2d 35 (Tenn. 1986), and that *Creasy* controls. We have determined that the Commissioner's reliance on *Creasy* is misplaced, because the facts are distinguishable. We have also determined that the surrounding facts and circumstances must be considered, in addition to the contract, to determine whether one is an agent or an independent contractor as proclaimed in *Boyd* and its progeny.

The issue in *Boyd* was whether Union Carbide, when serving as a contractor for the United States Government, was exempt from taxation under the Tennessee Retailers' Tax Act. *Boyd*, 363 S.W.2d at 199. Like here, the dispositive issue was whether Union Carbide's employees worked as agents or independent contractors for its client, the United States Government. If they were agents of the government, the government's tax immunity applied and, therefore, Union Carbide was exempt from taxation under the Tennessee Retailers' Tax Act. *Id.* If, however, Union Carbide's employees were found to be independent contractors, then Union Carbide was subject to the tax. *Id*.

In making its agency determination, our Supreme Court looked to the parties' contract and to the facts and surrounding circumstances. *Id.* As the Court stated: "The mere placing of terms such as agent or independent contractor in the contract does not make them such in law." *Id*. at 200. To the contrary, the Court stated you look beyond the contract and that "[t]he surrounding facts and circumstances determine the relationship." *Id*.

Maxim's Professional Service Agreement with its clients clearly supports the Department's argument that Maxim was an independent contractor, not an agent, because the Agreement expressly states such.[6] *Boyd* and its progeny instruct, however, that we must look beyond the contract to the facts and surrounding circumstances to see how the parties actually functioned. By looking beyond Maxim's Professional Service Agreement to the facts and surrounding circumstances, we see that Maxim's clients not only had the right to control Maxim's contract employees, but that the clients did in fact consistently exercise extensive, if not complete, control over the contract employees.

The undisputed facts established that the client informed Maxim of the client's specific requirements for each project, including the specific skills required and the task or assignment to which the contract employee would be assigned. Once Maxim received this information from the client, Maxim submitted candidates with the required skills to the client. The client then interviewed

[5] In their joint brief, the amici curiae adopted the brief of Teksystems in all respects and elaborated on the benefits the more than 15,000 temporary staffing firms provide to workers and employers, including the fact that temporary jobs regularly "serve as a bridge to permanent employment by giving workers an opportunity to learn new skills and gain experience with a variety of potential employers."

[6] The Professional Service Agreement stated in Paragraph 7.1 that the "Contractor would perform the services under this Agreement as an independent contractor." It further stated that "[n]o agency or employment relationship is intended nor shall be construed to exist between International Paper and Contractor or between International Paper and any employee of Contractor who performs Services under this Agreement. . . ."

each candidate and selected the IT professionals from the candidates submitted by Maxim. Once the client approved a candidate, Maxim formalized its employment contract with the candidate, now a contract employee of Maxim, and the new Maxim contract employee was instructed to report to the client's office where the contract employee would be supervised by the client for the term of the project.

Following their selection and placement, Maxim's interaction with its contract employees was very limited. This is because the contract employees worked at the client's offices and the contract employees submitted their weekly time sheets directly to their supervisor who was an employee of the client, not Maxim. If the client approved the time sheets, then the client submitted the approved time sheets to Maxim so that Maxim would pay the contract employees. Although Maxim's employees were under the direct supervision of the client, it is undisputed they were employees of Maxim. It is also undisputed that Maxim was solely responsible for payroll, withholding, employment taxes, and workers' compensation insurance.

Using International Paper as an example, it is undisputed that on a day-to-day basis, Maxim's employees worked under the direct supervision and control of International Paper's Information Technology managers, that International Paper determined the employee's hours, the location of their workspace, their specific tasks and assignments, and the deadlines for completion of the assignments. The employees' vacation days, sick days, and personal days were subject to the approval of International Paper's management. The contract employees attended department gatherings and status meetings held by International Paper, which occurred on a weekly basis, and they were required to comply with employment policies at International Paper such as dress code, standards of conduct, and International Paper's "Best Practices" policies.

Maxim's employees augmented or supplemented the client's already existing information technology department. For example, International Paper had approximately 1,000 of its own internal information technology professionals, and Maxim's employees worked in "teams" with International Paper's employees, and on rare occasions with contract employees from Maxim's competitors. The IT teams ranged from two individuals to twenty individuals, and the makeup of these teams was determined by the client, not Maxim. Further, Maxim's employees used the client's hardware, software, materials, and supplies in completing the projects, and if questions arose regarding the project, they directed the questions to the client's IT management, not Maxim.

As we stated earlier, the facts in this case are readily distinguishable from those presented in *Creasy*. Like Maxim, the plaintiff in *Creasy* was a company which provided computer programming consulting services to its clients, but unlike here, where the client determined its needs and designed the software programs, Creasy Systems Consultants determined the needs of its clients, Creasy determined the end product which the client wanted to produce, and then Creasy designed the programs. *Creasy*, 716 S.W.2d at 35. As the *Creasy* court noted: "So far as we can tell from the record, [Creasy's] clients were primarily interested in the end result – that is, a new or modified or debugged program for its computers that could be used satisfactorily by its employees." *Id*. at 36. In rejecting the argument that the contract employees were agents of the client, the court stated that the argument "does not fit the facts of the case." *Id.* at 37. Based on the above facts and "[u]nder its contract with the client," the *Creasy* court concluded that CSC was not an agent, but an independent contractor. *Id*.

Maxim's Professional Service Agreement notwithstanding, the undisputed facts in this case demonstrate that Maxim's clients, such as International Paper, exercised complete control over Maxim's employees in the performance of their work for the clients. The principal distinction in the law between one who functions as an independent contractor with that of one who functions as an agent of its principal is based on "*the extent of the control exercised"* over the agent or independent contractor "in the performance of his work." *Boyd*, 363 S.W.2d at 197 (quoting *Carbide*, 239 S.W.2d at 31) (quoting 2 C.J.S., Agency, § 2, p. 1027)). The long-settled test in Tennessee for agency is "whether the principal has a right to control the conduct of the agent with respect to matters entrusted to the agent."[7] *Sodexho*, 174 S.W.3d at 178.

> The "*right of control is the primary or essential test of an agency relationship* without which no agency exists. The same standard applies when the agency relationship is implied: *the right of the principal to control the agent's conduct or the actual exercise of such control is the essential test*."

Id. (quoting *Nidiffer v. Clinchfield RR. Co.*, 600 S.W.2d 242, 245 (Tenn. Ct. App. 1980)) (emphasis added). "The distinctions between an independent contractor and an agent are not always easy to determine, and there is no uniform rule by which they may be differentiated." *Id*. (quoting *Carbide & Carbon Chemicals Corp. v. Carson*, 192 Tenn. 150, 239 S.W.2d 27, 31 (Tenn. 1951)). The difference, as our Supreme Court explained in *Boyd* is:

> Generally the distinction between the relation of principal and agent and employer and independent contractor is based on the extent of the control exercised over the employee in the performance of his work, he being an independent contractor if the will of the employer is represented only by the result, but an agent *where the employer's will is represented by the means as well as the result*.

Boyd, 363 S.W.2d at 197 (quoting *Carbide*, 239 S.W.2d at 31) (quoting 2 C.J.S., Agency, § 2, p. 1027)) (emphasis added).

The legal principle stated in *Boyd* has been applied in *Raskin v. Johnson*, No. 01-A-01-9708-CH-00392, 1998 WL 242605 (Tenn. Ct. App. May 15, 1998) and *Sodexho Management, Inc. v. Johnson*, 174 S.W.3d 174 (Tenn. Ct. App. 2004). In *Raskin*, this court analyzed whether a private, for-profit manager of a city-owned golf course was an agent or independent contractor in

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[7]We reject the Commissioner's argument that if agency law is applied then the "modern version of intergovernmental tax immunity" should govern. The Commissioner contends that since the application of agency law to tax exemptions was derived from the analysis in cases concerning sovereign immunity or intergovernmental tax immunity, then the current "derivative" test should be applied. However, intergovernmental tax immunity is not an issue in this case, and we find no basis to apply a test other than the well-established test for agency in our state.

determining whether he was exempt from sales and use taxes based on the City's governmental immunity. In *Sodexho*, we were presented with the question of whether a private company, which provided food services for a tax-exempt university, was subject to taxation, or exempt as an agent of the university. As we noted in *Sodexho*:

> The employer may exercise a limited control over the work without rendering the employee a mere servant, for the relation of master and servant is not inferable from the reservation of powers which do not deprive the contractor of his right to do the work according to his own initiative so long as he does it in accordance with the contract. *The control of the work reserved in the employer which makes the employee a mere servant is a control, not only of the result of the work, but also the means and the manner of the performance thereof*; where the employee represents the will of the employer as to the result of the work but not as to the means or manner of accomplishment, he is an independent contractor.

Sodexho, 174 S.W.3d at 178-79 (quoting *Odom v. Sanford & Treadway*, 299 S.W. 1045, 1046 (Tenn. 1927)) (emphasis added). In *Sodexho*, this court was faced with the issue of whether the private company, Sodexho, could claim the tax-exempt status of the university for which it provided food services. Looking to both the contract between the parties and the facts and surrounding circumstances, we held that Sodexho was an independent contractor because "the control exerted by the university was *results oriented* and *did not constitute sufficient control over the means and methods* of Sodexho's food service operations to render Sodexho an agent of the university for purposes of the exemption." *Id*. at 183 (emphasis added).

Conversely, in *Raskin* we held that the private manager of a city-owned golf course was entitled to claim the tax-exempt status of the City. *Raskin*, 1998 WL 242605, at *1. Our inquiry focused on whether the golf course manager, in operating the golf course, was an agent or an independent contractor of the City. *Id*. We found that it was "the parties' actual conduct – and not just our interpretation of their contract" which was "relevant to the question of whether the City conducts, produces, or controls the golf course." *Id*. at *2. After considering the contract and the course of dealing between the manager and the City, we held that the manager was the City's agent because the City "retains control over Raskin's operation, exercising that control first through the City Finance Committee, and then through the Golf Course Commission which was created for that very purpose." *Id*. at *3.

Unlike in *Sodexho*, Maxim's clients exerted control over both the *means and methods* of the work performed by Maxim's employees. Using International Paper as an example, Maxim's employees worked in conjunction with employees of International Paper on projects wholly supervised by International Paper. Moreover, as distinguished from *Creasy*, Maxim's employees were not hired to develop a predetermined "end product," but the employees were selected and used by International Paper as part of a team to supplement and work under the direction of International Paper's personnel. While at International Paper, Maxim's employees were supervised by and reported to International Paper's managers on the projects to which they were assigned. Based on the undisputed facts and the reasoning outlined in the above cases, we find as a matter of law that Maxim's employees were acting as the agents of the client companies in fabricating the software. Therefore, Maxim was entitled to the "in-house" tax exemption under Tenn. Code Ann. § 67-6-102(36)(B).

In Conclusion

The judgment of the trial court is affirmed, and this matter is remanded with costs of appeal assessed against Appellant.

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FRANK G. CLEMENT, JR., JUDGE